BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
UNITED GROCERS, LTD.)

For Appellant: Robert C. Elkus, Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel; Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of United Grocers, Ltd., against proposed assessments of additional franchise tax in the amounts of $65,809.30 and $62,936.41 for the income years ending December 31, 1954, and November 30, 1955, respectively.

Appellant is a cooperative, nonprofit corporation, formed under the laws of California as a buying, marketing and service organization. It has no capital stock. Appellant's members are required to be engaged in the retail grocery, hotel, restaurant, baker's supply, general merchandise business, or any such other commercial activity deemed to have a common interest. The members each of whom is entitled to one vote, control the operation through an elected board of directors.

The privileges of membership are conditioned upon payment of the following amounts: (a) an initiation fee of $25, returnable if rejected for membership; (b) a membership certificate fee of $50; (c) a payment into a guarantee fund of $500 if the member desires deliveries from either the grocery or produce division (or $1,000 for deliveries from both the grocery and produce divisions, with lesser amounts for junior members); (d) monthly dues of $7.50 ($3.75 for junior members), treated by Appellant as contributions to capital; (e) a $3 fee for members desiring a withdrawal card; and (f) a transfer fee of $10 for new members succeeding to the business of a retiring member. Only items (b) and (c) are returned to members when they terminate membership in Appellant.

Certain amounts which are payable to a member as patronage refunds, as described in the following paragraph, may be required to be deposited in a special guarantee fund if the member is

considered a poor credit risk. These funds are held as security for the member's purchases and they earn 4 percent interest. The accrued interest may be withdrawn at any time and the principal amount of the deposit may be withdrawn at the end of ten years. In certain instances, the special guarantee fund includes amounts left with Appellant as time deposits, some of which are owned by nonmembers. Patronage refunds left on deposit with Appellant are callable by the member upon termination of his membership and all amounts credited to a member are subject to the claims of the member's creditors.

Appellant buys products and commodities in large quantities storing them in its own warehouses until they are sold. While Appellant does some business with nonmembers, approximately 95 percent of its sales are to its own members. Only the latter sales are taken into account when computing patronage refunds. At the time of sale, Appellant charges the prevailing market price for its goods. Once a year, the amount by which sales to members exceed Appellant's cost of goods sold and operating expenses is computed and distributed to members according to the volume of their purchases. These patronage refunds are made under the mandatory provisions of Appellant's articles of incorporation and bylaws. The articles state in part:

> The excess of its receipts from the obtaining for and delivery of goods to members over and above the expense of such obtaining and delivery is to be returned to the members in the form of patronage refunds, which shall be declared out during each calendar year.

The bylaws provide that patronage refunds shall be made in cash or in obligations of the corporation. After the patronage refunds are determined, each member is notified in writing of the amount he is to receive and the distributions are made by way of cash, credits or ten-year promissory notes bearing 4 percent interest.

On the theory that patronage refunds are merely price adjustments, Appellant has always excluded them from its gross income. Since Appellant considered monthly dues, initiation fees, transfer fees and withdrawal fees to be capital contributions, it did not include these amounts in gross income either. Amounts paid to members as interest on their special guarantee fund deposits and on Appellant's promissory notes were deducted as interest expense. The Franchise Tax Board's assessments were based on its determination that Appellant could not exclude patronage refunds from taxable income; that because of a 1955 amendment to Section 24405 of the Revenue and Taxation Code they were not deductible; that amounts paid as monthly dues, initiation fees, withdrawal fees and transfer fees constituted taxable income to Appellant and could not be treated as capital contributions;

and, that amounts paid as interest to members on their special guarantee fund deposits and on Appellant's promissory notes should be treated as dividends rather than interest.

Pursuant to stipulation, the Franchise Tax Board now concedes that amounts paid to Appellant's mernbers as interest on special guarantee fund deposits and on Appellant's promissory notes were properly deductible as interest expense. Further, Appellant now concedes that the amounts it received as monthly dues, initiation fees, withdrawal fees and transfer fees were not capital contributions and were properly includible in its gross income. The controlling issue remaining, therefore, is whether or not Appellant rnay exclude from gross income amounts paid to members as patronage refunds.

This same issue was recently decided by us in the Appeal of Certified Grocers of California, Ltd., Cal. St. Bd. of Equal., Sept. 20, 1962, CCH Cal. Tax Rep. Par. 201-976, 2 P-H State & Local Tax Serv. Cal. Par. 13285, wherein we held that the Legislature, by defining gross income in substantially the same terms as found in the federal law, adopted the federal practice of excluding patronage dividends, also referred to as patronage refunds, from gross income. Respondent does not dispute that the distributions here in question meet the conditions required to qualify as true patronage dividends or refunds under the federal rule. (See Pomeroy Cooperative Grain Co. v. Commissioner, 288 F. 2d 326; Farmers Cooperative Co, v. Commissioner, 288 F. 2d 315; Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201.) Accordingly, we conclude that Appellant is entitled to exclude patronage refunds from gross income.

ORDER

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of United Grocers, Ltd.,

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against proposed assessments of additional franchise tax in the amounts of $65,809.30 and $62,936.41 for the income years ending December 31, 1954, and November 30, 1955, respectively, be sustained with respect to amounts received by Appellant as monthly dues, initiation fees, transfer fees and withdrawal fees. In all other respects, the action of the Franchise Tax Board is hereby reversed.

Done at Fasadena, California, this 26th day of February, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary